South Carolina Legislative Audit Council

LAC

Report to the General Assembly

August 1995

A Review of the South Carolina Insurance Reserve Fund

LAC/IRF-94-4

Legislative Audit Council

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Executive Summary

At the request of members of the South Carolina General Assembly, we conducted a limited review of the state's insurance reserve fund (IRF). The insurance reserve fund is a section of the State Budget and Control Board's Office of Insurance Services and serves, in effect, as an "insurance company" for state and local governments.

This audit focuses on the effect of loans and transfers of revenues from the insurance reserve fund trust account. In addition, we examined the IRF's procurement of insurance from private insurance companies.

The following summarizes our review.

Loans and Transfers of IRF Funds

Since 1973, the General Assembly has required that part of the IRF's surplus funds (funds reserved to pay for losses in the event of a catastrophe or emergency) be loaned to various state agencies. In addition, the General Assembly has periodically transferred part of the IRF's surplus to the state's general fund. As of June 30, 1994, the IRF had approximately $120 million in surplus. However, $55 million of this amount has been loaned to state agencies or is reserved for loans to state agencies. Further, an additional $5.8 million in loans made from 1973 to 1986 is owed to the IRF. Our review of loans and transfers found the following.

Loans

- In 1981, the General Assembly authorized up to $35 million of the IRF's funds to be loaned to state agencies for various purposes. These loans, made through the Installment Purchase Program (IPP), have been at below-market interest rates. For two long-term loans that we examined, the IRF could have earned $5.2 million more from 1984 through June 1995 if the funds had been invested in United States government bonds (see p. 7).

- From 1982 through March 1988, state agencies obtained 35 short-term loans through the Installment Purchase Program, totalling $5.47 million, and the IRF received an interest rate on these loans of 8%. The IRF could have earned an average interest rate of 10.24% if these funds had been invested in short-term United States treasury notes (see p. 9).

- From April 1988 through January 1995, 45 loans totalling $12.4 million were made through the Installment Purchase Program, and the IRF received an interest rate of 6.5%. Short-term United States treasury notes would have paid the IRF an average rate of 7.25% during this time period (see p. 9).

- In 1987, the General Assembly authorized that up to $20 million of the IRF's surplus revenue could be loaned to the Savannah Valley Authority (now a division of the Department of Commerce) at an interest rate of 8% for up to 30 years. By comparison, long-term United States bonds paid a weighted average interest rate of 7.63% during the time period of these loans (see p. 9).

- The General Assembly has authorized additional loans with IRF funds. For example, in 1993, $2.5 million was loaned to the general fund to pay for the Catawba Indian settlement (see p. 10).

Transfers

- From 1978 through June 1984, the General Assembly transferred $32.6 million from the IRF to the state's general fund. Another transfer occurred in FY 91-92, when the General Assembly required that $9.5 million be transferred from the IRF to the state's general fund. If the $9.5 million had not been removed, an additional $2.3 million in interest income could have been earned between March 1992 and June 1995 (see p. 11).

Impact of Loans and Transfers

Loans and transfers impact the insurance reserve fund in several ways. First, the IRF uses investment income to lower premiums state agencies and local governments must pay. Therefore, when IRF funds are loaned to agencies at below-market interest rates, state agencies and local governments, in essence, must pay higher premiums to subsidize these loans. In addition, the IRF has less revenue available to pay for losses in the event of a catastrophe or emergency.

Further, in 1989 the federal government claimed part of the funds that were transferred from the IRF to the state's general fund, and the state paid $4.9 million to settle the claim; additional transfers of IRF funds to other accounts might require the state to pay the federal government a share of any transfer (see p. 12).

Administrative Issues

The IRF contracts with private insurance companies for certain lines of insurance. Our review of contracts for automobile liability, property reinsurance, and medical malpractice reinsurance found the following.

- The IRF has the potential to reduce operating losses by up to $1.7 million annually through self-insuring automobile liability insurance (see p. 16).

- The IRF has not competitively bid for property reinsurance since 1988 or medical malpractice reinsurance since 1984. While we did not find material problems with the IRF's reasons for not seeking bids for these lines of insurance, the IRF might wish to consider seeking bids for these lines to determine if better coverage can be obtained (see p. 18).

The IRF has not enforced the payment of premiums. As of February 1995, more than $7.8 million was owed. Approximately $2.2 million was 120 days past due, and some delinquencies are approximately 5 years old (see p. 20).

More than $27,000 in insurance debts owed by state and local governments have been written off since 1989; we could not find specific statutory authority which would allow debts to be written off (see p. 22).

We reviewed a sample of the IRF's expenditures for FY 92-93 and FY 93-94 to determine if the expenditures were related to the functions of the IRF. We found no material problems (see p. 24).

Conclusion

Loaning the IRF's surplus at below-market interest rates has caused state and local governments to pay higher insurance rates, because interest income is used to lower insurance premiums. State and local governments have also paid higher insurance rates as a result of the General Assembly transferring more than $42 million from the IRF's surplus from 1978 to 1992.

Introduction and Background

Audit Objectives

Members of the General Assembly requested that we conduct a review of certain aspects of the insurance reserve fund. We were asked to focus on the practice of loaning and transferring IRF funds and IRF's procurement of private insurance.

The objectives of our review are as follows.

1 Determine the amount of insurance reserve funds that have been loaned to other state agencies and the impact of these loans on insurance rates (see p. 7).

2 Determine the amount of funds that have been transferred from the insurance reserve fund to the state's general fund and the impact of transfers on rates (see p. 11).

3 Determine how the insurance reserve fund establishes rates, and if the fund solicits bids from private insurance companies (see p. 15).

4 Determine if the insurance reserve fund has an adequate process for resolving claims (see p. 23).

5 Determine if insurance reserve fund revenues have been expended for noninsurance purposes (see p. 24).

Scope and Methodology

Our review was limited to the above objectives. The primary scope of our review was from 1990 to May 1995. However, we examined some decisions that were made in the 1980s.

To conduct this audit, we examined financial and administrative records maintained by the IRF. We interviewed IRF staff and staff of other state agencies. We examined actuarial reports prepared for the IRF, reviewed IRF audited financial reports and internal reports prepared by the IRF.

To conduct this audit, we obtained computer-generated data of claims and expenditures and conducted random samples from the data. We compared the samples drawn from computer-generated data to other documents maintained by the division and found no inconsistencies.

We evaluated the insurance reserve fund's performance based on state laws and regulations and federal guidelines pertaining to the use of the IRF's funds. We surveyed officials in two states, Georgia and North Carolina, to gain perspective on their systems for obtaining insurance. This audit was conducted in accordance with generally accepted government auditing standards.

Background and History

South Carolina's insurance reserve fund (IRF) is a section of the State Budget and Control Board's Office of Insurance Services. It functions as an insurance company for governmental entities which operate in South Carolina. State agencies, local governments, school boards, and other government organizations are eligible to purchase insurance through the insurance reserve fund.

The insurance reserve fund began as part of the state's "sinking fund" for insuring state-owned property. A sinking fund is an account into which deposits are made to pay for future expenses, such as an insurance loss. Act 280 of 1870 established the general sinking fund. In 1900, the insurance sinking fund was established as part of the general sinking fund to insure public buildings. In 1916, public school buildings were specifically covered. Various acts changed provisions governing the fund, and the name was later changed to the South Carolina insurance reserve fund.

The insurance reserve fund operates within the Office of Insurance Services, (an office of the State Budget and Control Board) which was created in 1989. The office was formed by combining the insurance reserve fund section from the State Budget and Control Board's Division of General Services and the insurance benefits section from the South Carolina Retirement Systems.

As of June 30, 1993, the insurance reserve fund insured approximately $14 billion of governmental property, over 32,000 vehicles for liability, 190,000 governmental employees for tort liability, more than 5,000 school buses and 450,000 school bus passengers for school bus liability and pupil injury coverage, and approximately 1,700 physicians and dentists and 31 hospitals for professional liability.

The insurance reserve fund is responsible for writing insurance policies, establishing rates, investigating, settling, and defending claims, and purchasing appropriate reinsurance to protect the fund from excessive losses.

Another division of the State Budget and Control Board, internal operations, is responsible for certain aspects of the IRF's business. Internal operations bills and collects premiums, maintains accounts receivable and payable, and provides financial and management reports. The insurance reserve fund is funded with funds it earns, and receives no general fund appropriations.

The state treasurer is responsible for all investments and deposits of the insurance reserve fund's revenue. Funds have been deposited and invested in a variety of short- and long-term investments, including United States government securities, bank certificates of deposit, and repurchase agreements.

Insurance Coverages Offered

The following summarizes the types of insurance which state agencies and other governmental entities can purchase from the insurance reserve fund.

Property Insurance

The IRF insures property for fire and other perils, including earthquakes, hurricanes, floods, and sprinkler leakage damage for real property and its contents. The fund also insures data processing equipment and provides business interruption insurance, which reimburses revenue lost because of a fire, hurricane, or other insured disaster.

The fund provides "self-insurance" of up to $2 million per risk or location and $10 million per occurrence. Private insurance companies provide reinsurance for catastrophic coverage of up to $500 million. For example, if a hurricane caused insured losses of between $10 million and $500 million, the IRF's losses would be limited to $10 million, and the reinsurers would be liable for the remainder.

The fund also provides inland marine coverage, that is, specialized insurance. It pays for losses to items such as backhoes, band instruments, watercraft, contractor's equipment, museum items, and other properties which a governmental entity may have insured under an inland marine "floater" policy.

Automobile physical damage insurance is also provided. The fund pays the cash value of automobile damage or the cost of repairing the damage, whichever is smaller.

Liability Insurance

The insurance reserve fund offers various lines of liability insurance. General tort liability is sold to governmental entities and their employees. This insurance pays legal expenses and losses due to libel, false arrest, discrimination, denial of due process, violation of the first, fourth or eighth amendments to the Constitution, and other types of losses. Two limits on coverage are available—$500,000 maximum per occurrence and $1,000,000 per occurrence. Tort liability is completely self-insured; no reinsurance is purchased.

The IRF provides liability insurance for government-owned vehicles. A deductible of $250 applies to all claims. Coverage is 100% reinsured for up to $1 million for bodily injury and/or property damage.

Medical professional liability insurance (medical malpractice) is sold to governmental hospitals, physicians, dentists, and other health care providers. The IRF self-insures medical malpractice for the first $250,000 per occurrence; excess coverage for an additional $750,000 per event is reinsured by private insurance underwriters.

Other Insurance Offered

The IRF also insures underground storage tanks for petroleum products and pays for the expense of removing or cleaning up any leakage from these tanks. Pollution liability coverage is self-insured up to $1 million per occurrence.

No-fault accident insurance is provided by the fund for pupils and other passengers of school buses owned by the state and the school districts. The IRF pays up to $50,000 for death or dismemberment and up to $53,000 for medical expenses if there is no other insurance available for covering these costs.

Insurance is purchased by the IRF for certain state agencies to cover aircraft liability ($10 million per occurrence), boiler and machinery ($5 million), and ocean marine ($500,000 per vessel). The IRF purchases these insurance policies for agencies and bills the agencies for their share of the premium.

IRF Revenues and Expenditures

In FY 93-94, the IRF had revenues of $64.7 million and expenditures of $71.2 million. When expenditures exceed revenues, the IRF's surplus is reduced. When revenues exceed expenditures, surplus is increased. Table 1.1 lists revenues and expenditures and surplus for FY 93-94.

Table 1.1: IRF Revenues and Expenditures for FY 93-94

Operating Revenues	
Insurance Premiums	$48,788,735
Interest Income	$15,928,178
Total Income	$64,716,913
Operating Expenses	
Reinsurance Premiums	$25,774,245
Premiums	$243,239
Claims	$28,063,437
Professional Fees	$13,206,520
Administrative/Planning	$398,948
IRF Administration	$3,253,248
Bad Debts	$317,711
Total Expenditures	$71,257,348
Operating Income (Loss)	($6,540,435)
Transfers	($1,071,045)
Net Income (Loss)	($7,611,480)
Retained Earnings (Surplus)	
June 30, 1993	$127,779,838
June 30, 1994	$120,168,358

Source: IRF audited financial statements.

Use of IRF Funds

In this chapter, we examine the amount of loans that the General Assembly has authorized to be made with IRF surplus funds and review the impact of these actions on the IRF. In addition, we reviewed the effect of the General Assembly's decision in 1992 to transfer $9.5 million from the IRF's surplus to the state's general fund.

Loans and Transfers of IRF Funds

State law allows up to $55 million of the insurance reserve fund's surplus (money reserved to pay for potential disasters) to be loaned to state agencies to finance various projects. Section 1-1-1020 of the South Carolina Code of Laws allows up to $35 million to be loaned as part of the Installment Purchase Program (IPP) to finance various equipment needs for state agencies. In addition, up to $20 million can be loaned to the Savannah Valley Authority (now a division of the Department of Commerce) to finance infrastructure needs such as roads and water and sewer projects at Savannah Lakes Village.

In addition to the $55 million authorized, other loans have been made to finance construction costs and other state government projects. The following describes loans and transfers from the insurance reserve fund and their impact on insurance rates.

Installment Purchase Program

In 1981, the General Assembly passed §1-1-1020, authorizing the State Budget and Control Board's Division of General Services to borrow up to $25 million from the IRF to finance purchases for state agencies through the IPP. This ceiling was raised to $35 million in 1990. State agencies must use the funds they borrow to purchase office equipment, telecommunications equipment, data processing equipment, or medical equipment. In 1994, state law was amended to transfer authority for administering the IPP to the Office of the State Treasurer.

Under the IPP, the Division of General Services borrows IRF funds at an interest rate established by the State Budget and Control Board and then loans the money to state agencies at a slightly higher rate which is also approved by the State Budget and Control Board. The difference between these two interest rates is used to offset the cost of administering the loan. Originally, the IRF received 8% for all loans; in 1988, this was changed to 6.5% by the State Budget and Control Board. In 1984, the interest rate agencies paid for two loans we analyzed was 9.5%; in 1991 when the loans were refinanced, the agencies paid 8%. The rate that agencies paid has varied; the State Budget and Control Board sets the range, and the Office of the State Treasurer determines the rate within the range.

The insurance reserve fund has lost a significant amount of revenue through "below-market" interest rate loans to state agencies.

From 1981 through January of 1995, 90 loans totalling $48.5 million were made; $31.6 million (65%) of this total was loaned to either the Educational Television Commission or the Division of Information Resource Management. As of January 1995, there were 36 outstanding loans with a principal balance of $26.4 million.

We determined that the insurance reserve fund has lost a significant amount of revenue because the interest earned by loaning money to state agencies has been lower than the interest the IRF could have earned through investments in United States government bonds. The state treasurer is responsible for investing the IRF's surplus, and has invested in a variety of government securities and other investments. The IRF's policy is to use interest income to decrease insurance rates. Therefore, loaning the IRF's funds at below-market interest rates has resulted in the payment of higher insurance rates by state and local governments because the lost interest income is not available to effectively lower insurance rates.

We analyzed the amount of interest income that the IRF lost by making loans to two agencies, the Educational Television Commission and the Division of Information Resource Management. The IRF could have earned approximately $5.2 million more from late 1983 through June 1995 through investments in long-term treasury bonds (which were earning approximately 12% in 1983) rather than loaning the funds at 8% (later refinanced at 6.5%). For example, when ETV and DIRM borrowed $10.9 million and $12.6 million, respectively, in late 1983 through the IPP, long-term treasury bonds yielded approximately 12%. When the notes were refinanced at 6.5% in 1991, long-term treasury bonds yielded approximately 8%. This loss of interest income to the IRF for these two loans will continue until they are retired in the years 2003 and 2004.

In addition to these two long-term loans, state agencies have obtained below-market interest rate short-term loans. From 1982 through March 1988, 35 short-term loans totalling $5.47 million were obtained; the IRF earned an interest rate of 8% from these loans. The IRF could have earned an average interest rate of 10.24% if these funds had been invested in short-term United States treasury notes. From April 1988 through January 1995, 45 loans were completed totalling $12.4 million, paying the IRF an interest rate of 6.5%. The IRF could have earned an average interest rate of 7.25% if these funds had been invested in short-term United States treasury notes.

Savannah Valley Authority Loans

In 1987, the General Assembly passed a joint resolution which authorized the Savannah Valley Authority (SVA) to borrow up to $20 million of the insurance reserve fund's surplus. The amount which could be borrowed was limited to $3.5 million per year and the interest rate was set at 8% for a term of 30 years. The loan proceeds were required to be used to finance road, water, and sewer infrastructure. The loan is repaid from a special tax assessed on landowners in Savannah Lakes Village.

In a 1993 audit of the SVA, we concluded that unless tax deficiencies rise significantly or investment returns on funds (while on deposit) drop significantly, the Savannah Valley Authority should be able to repay the loans. As of January 1995, $11.3 million had been loaned to the SVA and the outstanding balance owed was $10.8 million. Since the inception of the program, the weighted average interest rate on 30-year United States treasury bonds has been approximately 7.63%. (This weighted average is based on the amount of funds loaned each year.) The IRF earned a slightly higher rate (0.37% more) than it would have through investments in long-term treasury bonds.

It should be noted that investments in SVA loans are probably riskier than investments in obligations of the United States government. United States government obligations are generally considered to be risk free, because there is little or no chance of default. In the competitive bond market, SVA loans might pay a higher interest rate than 8% because of their risk; they are not guaranteed by the county, but by the tax revenue generated by the development. If the special tax revenue is insufficient to repay the loan, the IRF has no other recourse for repayment.

Other Financial Commitments

The General Assembly has authorized additional loans to be made with IRF funds. These loans have been made to finance capital improvements and other state government obligations.

Catawba Indian Settlement

In 1993, the General Assembly loaned $2.5 million from the IRF to the general fund to pay for a portion of the Catawba Indian lawsuit settlement. The money is to be paid back over five years with state general funds.

The state treasurer set the interest rate. The rate was determined by taking the difference between the five-year treasury note rate and the five-year tax-free rate, which resulted in a rate of 4.5%. If the state treasurer had used the treasury note rate (the rate the IRF could have earned), the interest rate would have been 5%. By not using this rate, the IRF will lose over $32,000 in interest income.

State Budget and Control Board Loans

Various acts of the General Assembly authorized the State Budget and Control Board to obtain six loans totalling $11.4 million from the insurance reserve fund to finance various state projects. The terms of the loans ranged from 10 to 25 years at interest rates of 5% to 8%.

For example, $1.35 million was borrowed in 1973 to finance capitol complex renovations. As of June 1994, the outstanding balance of this loan was approximately $400,000.

In 1980, $825,000 was borrowed at 8% interest to finance renovations to the State Department of Education's Rutledge Building. As of June 1994, approximately $600,000 was still owed on this loan. Table 2.1 summarizes these six loans.

Table 2.1: Summary of State Budget and Control Board Loans of IRF Funds

Loan #	Year of Loan	Amount	Interest Rate	Term in Years	Purpose
1993C3	1973	$1,350,000	5%	25	Renovations to Capitol Complex
1993C4	1974	$4,500,000	5%	25	North Tower Building
1993C5	1974	$2,800,000	5.5%	25	DHEC Lab
1993C6	1975	$1,500,000	5.5%	25	DHEC Lab
1993C7	1980	$825,000	8%	20	Rutledge Building Repairs
1993C8	1986	$445,000	7%	10	DMVM Property

These six loans had an outstanding balance of more than $5.8 million as of June 30, 1994.

Forestry Commission Loan

The last four appropriation acts (FY 92-93 to FY 95-96) authorize the IRF to loan the Forestry Commission the amount needed to settle an overtime compensation claim which was initiated by the United States Department of Labor. No funds have yet been loaned to the Forestry Commission.

Transfer of Funds to the General Fund

From 1978 through 1992, the General Assembly transferred $42 million from the IRF to the state's general fund. These transfers were as follows:

- From June 1978 through June 1981, the General Assembly transferred $632,269 from the insurance reserve fund to pay for improvements to a water system on Broad River Road.

- In June 1984, the General Assembly transferred $32 million from the IRF to the state's general fund.

- In 1992, the General Assembly transferred $9.5 million of the IRF's revenue to the state's general fund.

From 1978 through 1992, the General Assembly transferred approximately $42 million from the IRF to the state's general fund.

We reviewed the effect of the 1992 transfer.

Section 14.89 of the FY 91-92 state appropriation act required that $9.5 million of the IRF's funds be transferred to the state's general fund. This has affected state and local governments in two ways. First, the $9.5 million reduced the amount of funds reserved to pay claims in the event of a catastrophe or other emergency. That is, if a disaster were to occur, there would be $9.5 million less available to pay claims. Second, the IRF uses investment income to lower the rates that they charge; the interest that the IRF could have earned on the $9.5 million would have been used to offset rates. The IRF could have earned approximately $2.3 million in interest income from March 1992 through June 1995 and lowered insurance premiums by that amount if the funds had not been removed from the fund.

The IRF opposed the transfer of funds. In a letter to the chairman of the House Ways and Means Committee dated February 20, 1991, the assistant director of the Division of Insurance Services stated, "It is the position of the Budget and Control Board, Division of Insurance Services that no funds should be transferred from the IRF Trust Account to the General Fund."

Unallowable Use of Federal Funds

Federal funds are used to help pay the costs of insurance of many state and local agencies receiving assistance under federal grants and contracts. Allowable costs under federal grants generally are governed by standards contained in Office of Management and Budget (OMB) Circular A-87. In the 1980s, the United States Department of Health and Human Services (HHS) audited the self-insurance funds (such as health insurance funds and insurance reserve funds) of several states and concluded that the federal government had been overcharged for insurance because states had accumulated excess funds.

In 1989, HHS issued an audit of South Carolina's self-insurance funds, including the IRF. The audit found that the IRF had accumulated excess reserves and made unallowable transfers (including those previously mentioned) of the excess funds. This conclusion was based on the HHS interpretation of OMB Circular A-87 which disallowed federal reimbursement for any increment above cost. According to HHS, any charges in excess of those for actual and probable losses would be disallowed. That is, "surplus" reserved to cover catastrophes, variations in loss experience, and other unexpected events would be disallowed, and the federal government would be entitled to reimbursement for the portion of the surplus that they funded. The report recommended that South Carolina reimburse the federal government $24.5 million. The IRF disagreed with the findings and recommendations. In 1990, the state settled with the federal government for $4.9 million.

South Carolina would probably be required to refund money to the federal government if the IRF's funds are transferred to other accounts.

During our review, OMB Circular A-87 was amended, generally effective September 1, 1995. One amendment will require that whenever funds are transferred from a self-insurance reserve to another account, such as a general fund, the federal government is to receive a refund for its share of funds transferred, including interest. Under this provision, South Carolina would probably be required to refund money to the federal government if IRF funds are transferred to other accounts. It should be noted that OMB Circular A-87 also provides that contributions to a reserve for certain self-insurance funds are allowable to the extent that the type of coverage, the extent of coverage, and the rates and premiums for such insurance would have been allowed had private insurance been purchased to cover the risks.

Conclusion

While loans to state agencies at below-market interest rates provide a benefit to the agencies receiving the loans, other state agencies and local governments in effect pay for these benefits through higher insurance rates. This is because interest income is used to reduce insurance rates and less interest income is earned when funds are loaned at below-market rates. In addition, these loans are considered illiquid, and in the event of a major catastrophe or emergency, the amount of surplus funds available to pay claims might not be sufficient. In that event, the IRF might have to raise insurance rates.

It would be in the state's best interest for agencies that need to borrow funds over a long period of time to seek financing from state general obligation bonds or other sources, since general obligation bonds generally carry a lower rate because interest is free of state and federal income taxes. In addition, funds could be requested through capital reserve fund appropriations.

Recommendations

1 When IRF funds are loaned through the Installment Purchase Program, the State Budget and Control Board should require that the interest rate paid to the IRF be at least the rate which could be earned on comparable United States government notes or bonds, or other comparable investments made by the treasurer.

2 The General Assembly may wish to consider amending §1-1-1020 of the South Carolina Code of Laws to allow for only short-term loans (five years or less) from IRF funds.

3 The General Assembly may wish to consider requiring that all future loans of IRF funds pay the IRF, at a minimum, the interest rate that United States government obligations would pay for the same time period of the loan. In addition, the General Assembly should consider requiring that all future loans of IRF funds be short-term, that is, five years or less.

4 The General Assembly should evaluate the effect to the IRF before transferring any IRF funds to the state's general fund.

Administration

In this chapter, we discuss how the IRF establishes insurance rates, and contracts for insurance with private companies. We also address other administrative issues.

Establishing Insurance Rates

The insurance reserve fund is responsible for establishing rates which ensure that current and future claims can be paid. To assist in establishing adequate rates, the IRF contracts with an actuarial company to examine claims data and recommend rates which should be charged. The actuarial consultants review liability rates annually and property rates every other year.

In establishing rates, actual loss data for previous years are collected and examined for trends. Next, claims are projected into future years. The expected dollar loss for the upcoming year is determined by multiplying the projected frequency of claims times the average claim cost. Added to that amount are the estimated expenses for legal fees and costs of independent adjustors. The insurance reserve fund then determines the amount of investment income it will earn from its reserves and surplus funds, and subtracts it from projected claims and expenses. This amount is divided by the number of policies written to develop the rate charged to governmental entities.

In addition, the insurance reserve fund must have adequate surplus funds to pay for catastrophic loss and other emergencies. For example, an unexpected number of tornadoes may cause more property claims to be paid than originally planned. Surplus funds must also be available to pay for losses associated with other types of catastrophes, such as earthquakes or hurricanes. As of June 30, 1994, IRF had a surplus of $120,168,358 available to pay for catastrophic losses. (As previously discussed, part of this amount is invested in long-term loans and is not readily available.) The IRF also purchases property reinsurance, which will pay for losses exceeding $10 million (up to $500 million) for each occurrence. We found no material problems with the IRF's system for establishing rates based on our review of actuarial projections.

IRF Contracts For Insurance

The insurance reserve fund contracts with private insurance companies for various kinds of coverage and "reinsurance" (coverage of a portion of the risk). For example, the IRF contracts with a private insurance company to provide all automobile liability insurance coverage. The IRF contracts for reinsurance to pay for catastrophic loss to state and local government property. These contracts are rebid or renewed by the State Budget and Control Board on a five-year basis, with yearly negotiations of rate changes. In addition, the IRF annually purchases medical malpractice reinsurance for government-owned hospitals and public health care providers. The results of our review of IRF contracts for automobile liability, property reinsurance, and medical malpractice reinsurance are discussed below.

Automobile Liability Insurance

The insurance reserve fund has the potential to significantly reduce operating losses by self-insuring automobile liability insurance. These savings could be ultimately passed on to governmental entities.

Automobile insurance is 100% reinsured with a private insurance company, and in policy year February 1, 1994, through February 1, 1995, the premium was $16.5 million. However, IRF charges to state and local agencies for this insurance were approximately $13.5 million, resulting in a $3 million loss which was absorbed by the IRF.

The insurance reserve fund has contracted with this company since 1988. According to IRF documents, before policy year 92-93 the annual loss on liability claims was $12 to $12.5 million. However, in policy year 92-93, the estimated losses increased to $16 million. An IRF review of liability claims found that the private company was improperly managing claims and over-reserving for estimated losses, causing increased costs that were being passed on to the IRF. (The company later reduced the reserves.)

In 1994, IRF staff recommended that the contract with the private insurance company be terminated for the following reasons:

- IRF assets are sufficient to self-insure this line of insurance, which is very stable (claims are predictable, not subject to large variances and limited by law).

- The cost of reinsurance includes the company's profit. Because IRF does not operate at a profit, insurance can be provided for about 25% less.

- The private company's claims service is greatly increasing the cost of claims. This will be reflected in future premiums to the insurance company.

The IRF could reduce operating losses by $1.7 million annually by self-insuring automobile liability insurance.

In December 1994, the State Budget and Control Board instructed the IRF to negotiate the premium rate, which resulted in a premium reduction of $800,000, reducing the premium to $15.7 million for policy year 95-96. According to IRF staff, the board, in executive session, also instructed the IRF staff to make recommendations in summer 1995 concerning renewal of the contract. The IRF estimates that after paying additional claims adjusting and processing expenses, it can provide the same service and save $1.7 million annually.

Other options which the IRF is currently reviewing are:

- Continuing the contract with the private company and raising rates to state agencies and local governments.

- Self-insuring a portion of the coverage and purchasing reinsurance to cover large losses.

The insurance reserve fund self-insures other lines of insurance. For example, tort liability for governmental officials is self-insured. In addition, automobile collision and comprehensive insurance is completely self-insured. The IRF self-insures the first $10 million of property losses for multiple claims resulting from a catastrophic occurrence.

Recommendations

5 The State Budget and Control Board should reexamine its contract for automobile liability insurance and consider self-insuring automobile liability.

6 If the State Budget and Control Board does not completely self-insure automobile liability, it should consider self-insuring a portion of the risk and purchasing reinsurance for the remainder.

7 If the State Budget and Control Board decides to continue 100% reinsurance for automobile liability, it should consider soliciting bids to determine whether coverage could be purchased at a lower cost.

Property Insurance

The insurance reserve fund self-insures the first $2 million of an individual property claim. For multiple claims caused by the same catastrophe, the IRF self-insures for $10 million. The IRF contracts for reinsurance to pay claims which exceed these limits, with a maximum liability of $500 million. This reinsurance costs approximately $8.8 million annually.

In 1983 and 1988, the IRF attempted to competitively procure property reinsurance. In 1983, the bid was unsuccessful because the lowest responsive bid lacked sufficient guarantees to pay potential claims. As a result, the State Budget and Control Board invoked its statutory authority to exempt IRF from competitively bidding for this reinsurance. The contract was then awarded to the agency submitting the next lowest bid.

In 1988, another attempt to bid property reinsurance failed because the two bids were declared to be nonresponsive bids. The State Budget and Control Board instructed the IRF to negotiate with the broker submitting the low bid concerning the conforming language necessary to make the bid responsive. The reinsurance contract was awarded to this agency, the same agency that had been selling property reinsurance to the IRF.

The IRF has not solicited competitive bids for property reinsurance since the unsuccessful attempt in 1988.

The insurance reserve fund has not attempted to bid for property reinsurance since 1988. According to IRF staff, the market for property insurance is not competitive because of large losses experienced by insurance companies due to recent major catastrophes throughout the country. The IRF staff explained that the present reinsurers have performed well in paying claims for catastrophic loss. We asked an official with the South Carolina Department of Insurance if property reinsurance should be bid. He stated that it is important to purchase reinsurance from companies with adequate resources to pay potential claims, and confirmed statements by IRF staff that, due to recent catastrophes in this country (hurricanes, floods, and earthquakes), it would be difficult for South Carolina to obtain a good price for property reinsurance.

Recommendation

8 The insurance reserve fund should continue to monitor the market for purchasing property reinsurance. The State Budget and Control Board may wish to solicit bids for property reinsurance if the market for purchasing property reinsurance improves.

Medical Malpractice Insurance

Currently, the insurance reserve fund self-insures the "primary layer" of medical malpractice, which covers losses of up to $250,000 per claim. Reinsurance is purchased to cover losses over $250,000 with a maximum liability of $1 million. This reinsurance costs 14% of the premiums billed to health care providers and hospitals, which is estimated to be $1.2 million for policy year 94-95.

In 1984, the insurance reserve fund made two attempts to competitively purchase medical malpractice reinsurance. On both occasions, the bids were determined to be unacceptable.

In September 1984, the State Budget and Control Board authorized the IRF to negotiate with appropriate insurance companies for medical malpractice coverage. The State Budget and Control Board authorized the IRF to contract for medical reinsurance effective October 1984. This contract has been continuously renewed and is scheduled to expire in November 1995.

We asked IRF officials why medical malpractice insurance has not been competitively bid since 1984. IRF officials indicated that it is important to maintain a long-term relationship with a dependable insurance carrier. They indicated that in the early 1980s, it was difficult to purchase medical malpractice insurance, but the market has since improved. We also contacted an official with the Department of Insurance. He stated that while it is important to obtain a long-term relationship with medical malpractice insurers, the market is more competitive than it was in the 1980s.

In addition, we asked why the IRF purchases reinsurance for medical malpractice insurance, given that maximum claims are $1 million and, similar to auto liability, claims experience is fairly stable. According to the IRF's actuarial consultant, the private insurance companies' rate for reinsurance, which would pay up to $750,000 per claim, is 20% cheaper than the IRF would have to charge to make complete self-insurance actuarially sound.

Recommendation

9 The State Budget and Control Board may wish to determine, by soliciting bids, if other reliable insurance companies can provide medical malpractice reinsurance at a lower rate.

Unpaid Premiums

The IRF has not enforced the collection of unpaid insurance premiums. As a result, IRF is losing premiums and investment income. This loss of income affects insurance rates paid by state agencies and local governments.

As of February 3, 1995, the IRF was owed more than $2.2 million in premiums that were more than 120 days past due.

As of February 3, 1995, the IRF was owed more than $7.8 million in premiums. Approximately $2.2 million (29%) was over 120 days past due. We found that 23 entities owed a total of more than $250,000. For example:

- One state agency owes almost $13,000 in delinquent premiums. These premiums were due from November 1990 through December 1992.
- One county owes more than $55,000 in premiums due between 1990 and 1993.
- One school district owes almost $53,000 in premiums due in 1992.

South Carolina Code of Laws §10-7-100 requires that insurance premiums due to the State Budget and Control Board be paid upon demand. The board may charge 5% interest on all amounts due and unpaid. If the premium is not paid, the board has several collections options which include:

- South Carolina Code §10-7-110 requires the board to notify the state treasurer of any county or political subdivision that has become delinquent by more than one year in the payment of premiums. The state treasurer must then withhold funds from the county's next distribution of the gasoline tax.
- South Carolina Code §10-7-150 requires the board to notify officials of the expiration of policies insuring buildings. If the funds are not available to pay the premium, the premium must be paid (with interest) out of the first funds available.
- South Carolina Code §11-9-75 allows the board to notify the state treasurer if any county or municipality is delinquent for 90 days on any

payment to the IRF. The treasurer will then withhold the delinquent amount from the next distribution of any revenue.

We asked IRF staff why enforcement action has not been taken to collect delinquent premiums. According to IRF staff, they have no system for assessing 5% interest for delinquent accounts or withholding gasoline tax distributions from delinquent counties. There is also no system or procedure for notifying insured entities or the state treasurer of delinquent premiums so that enforcement can be taken.

Section 15-78-160 of the Tort Claims Act states that the board is not liable for risks if an agency fails to pay a required premium and a policy is cancelled. While this section does not outline conditions in which policies can be cancelled for nonpayment, it implies that the IRF has the ability to cancel policies for nonpayment.

Reviews of the IRF conducted by the South Carolina Department of Insurance in 1987, 1990, and 1993, recommend that the IRF review its collections process. The department stated that the amount of overdue premiums continues to be greater than insurance industry standards.

Recommendations

10 The State Budget and Control Board should implement a system to promptly enforce the collection of past due insurance premiums.

11 The General Assembly may wish to consider amending South Carolina Code §10-7-100 to specify when the State Budget and Control Board can cancel policies for nonpayment of premiums.

Write-Off of Debts

In January 1989, the State Budget and Control Board's Division of General Services, which administered the IRF, established a policy to write off uncollected premiums which are at least six months old and do not exceed $50. (The IRF also writes off certain refunds not exceeding $50, though not governed by a written policy.) Our review found that:

- Debts which exceed $50 have been written off, thereby not complying with the IRF's policy.
- Local government and state agencies which currently purchase insurance through the IRF have had debts written off.
- State law does not specifically allow the State Budget and Control Board to write off debts. In addition, we could find no evidence that the State Budget and Control Board approved their staff's policy which allows debts to be written off.

From July 1989 through April 21, 1995, the IRF wrote off more than $27,000 in delinquent premiums. During this time period, the IRF also wrote off over $2,400 in refunds owed to government entities. For example, in FY 93-94, instead of paying $48 owed to one county for an automobile insurance policy refund, the IRF wrote it off. Most of the premiums written off were owed to the IRF dating from 1986 through 1989 when the IRF was part of the Division of General Services. For example:

- One nursing home owed over $11,000 in professional liability insurance premiums that were due from 1987 through 1989. This amount has been written off. This nursing home now owes more than $23,000 in professional liability premiums due from 1990 through December 1994.
- One university owed more than $4,000 in property and professional liability premiums dating from 1986. This amount has been written off. This university now owes over $9,000 in property insurance premiums dating from 1990.

We could not determine why these debts were written off. Governmental entities which have had debts written off continue to purchase insurance from the IRF and state law outlines procedures to collect debts (see p. 20).

Recommendations

12 The State Budget and Control Board should review the practice of writing off debts to determine if it has legal authority to write off debts. If the State Budget and Control Board determines that it does not have the authority to write off debts and wishes to continue this practice, it may wish to request specific legislative authority setting parameters in which a debt can be written off.

13 If the practice of writing off debts continues, the insurance reserve fund should comply with its policy and not write off debts which exceed the limits of its policy concerning write-offs. Any debts written off should be determined uncollectible.

Resolving Claims

The insurance reserve fund is responsible for the resolution and payment of insurance claims. Section 1-11-140(A) of the South Carolina Code of Laws gives the State Budget and Control Board "exclusive control over the investigation, settlement, and defense of claims . . . ." We reviewed a sample of 83 claims files that the IRF closed in 1994. We found documentation supporting the claim amount paid by IRF. We found no material problems regarding the resolution of claims that we examined. However, the following claim has yet to be resolved.

Charleston School District Claims

As of May 1995, Charleston County School District has a lawsuit pending against the IRF involving damage from Hurricane Hugo. IRF has paid the district $12.6 million for Hugo claims. The district alleges that the IRF refuses to pay the actual cost of the repairs and owes an additional $14.5 million. IRF argues that the additional claims are for services and repairs not covered by the policy, for damages due to inadequate maintenance, and for repairs which exceeded the reasonable cost. The South Carolina Supreme Court has ordered an appraisal process to attempt to resolve the dispute.

Insurance Reserve Fund Disbursements

One of the objectives of this audit was to determine if funds from the insurance reserve fund had been expended for "noninsurance" purposes. That is, have funds been expended which do not relate to the function of the IRF. We reviewed a sample of 51 expenditures for FY 93-94 and 6 expenditures for FY 92-93 totalling $1,854,426.14. This review included expenditures for travel, the payment of claims, attorneys' fees, adjusters, and other administrative expenses. We found no material problems in our review of IRF expenditures.

Agency Comments

STATE OF SOUTH CAROLINA

State Budget and Control Board

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JAMES E. BENNETT, CPCU
DIRECTOR

HAND DELIVERED

August 14, 1995

Mr. George L. Schroeder
Director
Legislative Audit Council
400 Gervais Street
Columbia, South Carolina 29201

Dear Mr. Schroeder:

Thank you for the final draft of the LAC Audit of the Insurance Reserve Fund and for the opportunity to respond to the issues raised in the Audit.

At the outset, I would like to express my appreciation for the professionalism displayed by your staff during the course of the audit. They were extremely knowledgeable about governmental operations and the audit proceeded in a timely and efficient manner.

I offer the following comments:

1. The last paragraph on page 4 states; "Insurance is provided for certain state agencies to cover aircraft liability ($10 million per occurrence), boiler and machinery ($5 million) and ocean marine ($500,000 per vessel)." Although the IRF purchases aircraft and ocean marine insurance for certain state agencies, the boiler and machinery program is reinsurance and provides reinsurance coverage to every property policy issued by the IRF.

2. Pages 7 through 14 of the audit deal with use of IRF funds. The audit correctly identifies the fact that the various loans using IRF funds and transfers of monies from the IRF to the State's General Fund resulted from legislative action. The IRF must operate in accordance with statute. While I generally agree with the audits recommendations, the IRF cannot implement the recommendations contained in this section, unless there is Legislative action.

3. On page 17, in regard to Automobile Liability Insurance, the report states; "In December, 1994, the State Budget and Control Board instructed the IRF to negotiate the premium rate, which resulted in a premium reduction of $800,000, reducing the premium to $15.7 million for policy year 95-96." In Executive Session on December 13, 1994, the Board received from staff recommendations which involved several options due to the time frame regarding expiration of the current contract. As a result of the presentation, staff negotiated a $800,000 reduction in the premium for the 95-96 contract year. Also, Insurance Services staff were requested to report back to the Board during the summer of 1995 with recommendations for changes to the current program. The research is now complete and staff plans to present recommendations to the Board at the August, 1995 meeting.

4. On pages 18-19, in regard to recommendations on property reinsurance, IRF staff will continue to monitor the property catastrophe market. The current program is authorized for the period 7-1-93 through 6-30-98. IRF staff will be prepared to make recommendations on this program to the Budget and Control Board in the fall of 1997. We appreciate the auditor's comments confirming the current state of the reinsurance market due to numerous catastrophes during the past several years.

5. On page 20, in regard to recommendations on medical professional liability reinsurance, IRF staff will review the professional liability market in FY 95/96 and make recommendations to the Budget and Control Board on this subject in the spring of 1996.

6. On page 20 and 21, in regard to Unpaid Premiums, in general, your criticisms are valid and are being addressed:

    (a) Having previously recognized the problems with current statutory language, Part II, Sec. 7 of the 1995/96 Appropriations Act amended Section 11-9-95 to authorize the Budget and Control Board to transfer any funds remaining in the agency's account at the end of the fiscal year to pay outstanding insurance premiums.

    (b) The Insurance Reserve Fund is initiating a review of internal procedures and will present to the Budget and Control Board recommendations to bring non-payment procedures more in line with standard insurance practices. Proposed legislative changes will be prepared and presented to the General Assembly upon approval by the Board.

(c) Finally, it should be noted that the bulk of unpaid premiums are owed by local government. Cancellation of insurance, in many cases, causes the local government agency to cease operations and terminate services to the citizens of this State. A recent example was the cancellation of the Tort and Automobile liability coverages for Upper Piedmont Regional Transportation Authority due to non-payment of premiums. Therefore, the Insurance Reserve Fund has, in the past, been hesitant to exercise authority to cancel insurance so long as there was some reasonable expectation of payment.

7. On page 22, in regard to "Write-off of Debts," I offer the following comments:

(a) Previous audits have recommended that certain debts be written off, even though efforts to collect were on-going. One example is a recommendation to write off a particular debt in the Rogers Montgomery audit for June 30, 1993.

(b) Credit and debit invoices remain viable even after they are "written off" and can be submitted by the insured at any time.

(c) The $27,000 referred to in the audit as being written off is approximately 0.0014% (14 ten thousand of one percent) of the total premium written during that time period, and, therefore, was not considered significant or material.

(d) Cancellation of policies for certain political subdivisions, under current statutory limitations, will result in the earned premium from those cancellations being uncollectible, and therefore, necessarily "written off" as bad debts.

In general, the Audit raises issues of which we were aware and, to the extent possible, are being addressed. Again, I appreciate the professional manner in which your staff conducted this audit.

Sincerely,

James E. Bennett

James E. Bennett, CPCU
Director
Office of Insurance Services

STATE OF SOUTH CAROLINA

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August 2, 1995

Mr. George L. Schroeder
Director
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400 Gervais Street
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Dear George:

Thank you for your letter of July 25, 1995, in response to some of our inquiries on the IPP portion of the Legislative Audit Council's Draft Report on the Insurance Reserve Fund. The Treasurer appreciates your and your staff's work on this project.

Treasurer Eckstrom believes that the paramount mission for State Government is to provide the taxpayers and citizens of this State with needed and essential services through the most cost effective methods. Although our Office may differ with some of the comments and conclusions in the Draft Report, we believe your focus is similar to the Treasurer's. The Treasurer also believes that these matters need to be reviewed with as much information available and as many differing perspectives as possible so that the best decision may be made.

If this Office may be of any further assistance on this matter, please call us.

Sincerely yours,

James M. Holly
Chief of Staff

JMH:cp

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